

No. 15207

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

C. H. WENTWORTH,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITIONER'S OPENING BRIEF.

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Preliminary Statement.

Petitioner seeks to have reviewed by this Court a decision of the Tax Court of the United States determining a deficiency in income tax for the taxable year ended December 31, 1947, in the amount of \$60,902.38. All of the evidentiary facts were stipulated to by the parties before the Tax Court, no further evidence being introduced at the time of trial. The sole issue presented is whether or not the stipulated evidentiary facts support a finding that a payment received by Petitioner from a corporation in 1947 constituted the payment of notes receivable, as contended by Petitioner, or constituted a dividend to the extent of corporate earnings, as contended by the Respondent.

The Record Below.

The entire record herein, except the ultimate finding of the Tax Court, was stipulated to by the parties and as this stipulation is one of the Exhibits before this Court, Petitioner will not recite at length all of the facts therein but will refer briefly to the salient happenings leading to this litigation.

On January 1, 1943, Petitioner transferred to Flexo Manufacturing Co., Inc., hereinafter referred to as "corporation," substantially all of the assets, liabilities and reserves of his sole proprietorship business in the amount of \$152,737.44, book basis. Petitioner received 120,830 shares of stock and transferred 5 shares to a Mr. Steele, and the corporation sold 4,167 shares for cash to a Mr. Wallmer. On February 27, 1943, Petitioner loaned to the corporation the sum of \$100,000.00 and received back its promissory note payable in one year at 6% interest. On April 14, 1943, an additional loan of \$100,000.00 was made to the corporation by Petitioner and a similar note taken back, maturing in one year at 6% interest. The corporation carried an open account on its books in the Petitioner's name which, on December 31, 1943, showed a debit balance of \$197,211.03. Both notes were carried on the corporate books as "notes payable." On October 31, 1944, the corporation credited the open account with \$180,000.00, leaving a debit balance of \$20,742.60, and at the same time charged its capital account resulting in a capital deficit of \$23,095.56. The notes payable account was not disturbed and the notes were not surrendered. In May, 1947, Petitioner received the sum of \$200,000.00 from the corporation and surrendered to the corporation the two promissory notes and the notes payable account was debited and the notes cancelled.

From these facts, the Tax Court found that the credit to the accounts receivable account in 1944 “worked a corresponding offset” in the notes payable account resulting in a corporate distribution in 1947 to the extent of earnings and profits in that year.

The Stipulated Facts Conclusively Show That the Notes Were Paid in 1947.

It is self-evident from the facts agreed to by the parties that the real intention of Petitioner and the corporation was that the notes be paid by the 1947 payment. Every fact in the record substantiates this conclusion. Promissory notes were issued to Petitioner in consideration of the two \$100,000.00 loans and a notes payable account entered on the books of the corporation. Upon receiving payment of the amounts due on the notes in 1947, Petitioner surrendered them to the corporation which, in turn, debited its notes payable account. Thus, all of the direct and critical circumstances related to the transaction lead cleanly to the conclusion that the parties intended and treated the payment in 1947 as on the notes. Petitioner submits that this is an obvious and simple deduction.

The rationale of the majority opinion of the Tax Court is that the receipt by Petitioner of \$180,000.00 in 1944, which was charged to the corporation’s capital account, was really intended by Petitioner and the corporation as a payment on the notes. In order to reach this position, it is necessary for the Tax Court to disregard the form in which both the 1944 and the 1947 payments were cast and to disregard the fact that the notes remained outstanding until cancelled upon the payment in 1947. Boiled down, the Tax Court’s opinion hinges on the fact that

Petitioner paid no tax on the payment in 1944, and on the assumption that Petitioner *actually* knew that, if such were a return of capital, some tax would be payable. Petitioner submits, in agreement with the dissenting opinion below, that at most the failure to report a taxable dividend for the year 1944 showed that Petitioner did not understand the tax consequences of a return of capital in the amount received. Petitioner's tax treatment of the 1944 payment is at the very most equivocal in support of the Tax Court's finding. There was nothing equivocal, however, in the manner in which the 1944 payment was reflected by the corporation's books. It was shown to be a return of capital and nothing else.

Thus we see ranged on the one hand, all of the usual indicia of payment to indicate the notes were retired in 1947, and on the other hand, to indicate payment in 1944, a questionable supposition based upon an equivocal fact.

It is to belabor the obvious to restate that all of the substantial and uncontroverted evidence in the record is in support of Petitioner and that there is no substantial evidence in support of the majority opinion reached by the Tax Court.

The case should be remanded for action favoring Petitioner's contentions.

Fed. Rules of Civ. Proc., Sec. 52(a);

Wright-Bernet, Inc. v. Comm., 172 F. 2d 343 (1949).

The Holding Below Allows the Commissioner to Open a Year Barred by the Statute of Limitations.

Judge Murdock, dissenting, stated:

“Labored reasoning is used in the prevailing opinion to bail out the Commissioner after the statute of limitations has run against an earlier year in which he should have taken the action which he is now taking.” [Tr. of Record p. 24.]

Petitioner respectfully submits that it is again self-evident that the thrust of the Tax Court's holding is to obtain tax revenue from the transaction in 1944 although it is barred by the Statute of Limitations. This is contrary to law.

Ross v. Commissioner, 169 F. 2d 483;

Commissioner v. Dwyer, 203 F. 2d 522, 524;

Richard K. Mellon, 12 T. C. 90, 110;

American Light & Traction Co., 42 B. T. A. 1121,
aff'd 125 F. 2d 365;

Tide Water Oil Co., 29 B. T. A. 1208;

James Couzens, 11 B. T. A. 1040.

The Holding of the Tax Court Exceeds Its Authority.

Petitioner respectfully submits that the underlying premise of the Tax Court's opinion is that the notes were paid by *operation of law* and for *tax purposes* in 1944 contrary to and in the face of the real intention of the parties to have payment in 1947. Substance must prevail over form for the Government as well as the taxpayer and there is no legal basis for the Government to avoid the substance of the transaction herein.

Weiss v. Stearn, 262 U. S. 242, 68 L. Ed. 1001,
44 S. Ct. 490 (1924).

A careful reading of the majority opinion will reveal that the Tax Court never actually states that the parties *intended* the payment in 1944 to be on the notes. To be sure, the holding is that the 1944 payments are *to be treated* as against the notes, but there is a scrupulous avoidance of any expression that the parties so intended. Even the headnote of the holding states that “. . . under these circumstances the credit to the accounts receivable account in 1944 *worked a corresponding offset* in the notes payable account . . .” [Tr. of Record, p. 15 (emphasis added).]

This brings into play some theory of equity or estoppel or operation of law not argued by the Government, not expressed by the Court nor supported by the law. As expressed by the Court itself, the turning question is “. . . what the parties actually did . . .” [Tr. of Record, p. 19.]

One further point will serve to illuminate this contention. Suppose the taxable nature of the 1944 payment were the only issue before the Court. Does it seem possible that the Petitioner could, on the facts agreed to, successfully urge that the 1944 payment constituted note payments? It is readily apparent that the Government would most certainly tax it as a corporate dividend and Petitioner would be powerless to argue that he did not actually receive note payments in 1947.

If the Court agrees with this analysis of the taxable nature of the 1944 payment, then it follows that the Tax Court has improperly tied together two unrelated trans-

actions by some silent doctrine and that its findings must be overturned.

Union Pacific R.R. Co. v. Comm., 32 B. T. A. 383 (1935);

Wobber Bros. v. Comm., 35 B. T. A. 890 (1937);

Grauman's Greater Hollywood Theatre, Inc. v. Comm., 37 B. T. A. 448 (1938);

Salvage v. Comm., 76 F. 2d 112 (1935), aff'd 297 U. S. 106.

Conclusion.

The issue in this case is very simple. Were the notes paid in 1947? All of the direct evidence would indicate that they were. Both the payee and the payor acted in support of this assertion by (1) surrendering the notes, and (2) debiting the notes payable account, respectively, in 1947. The most powerful evidence of payment necessarily is whether the instrument has been surrendered and, secondly, how the payor treated the payment on his books or records.

The corollary issue present is whether payment was made in 1944. It should be noted that although \$180,000.00 was paid, neither note was surrendered nor was the note account debited. The evidence shows that both Petitioner and the corporation regarded the 1944 payment as a return of capital and that they most certainly did not intend or regard it as being against the notes.

The entire theory of the Tax Court ruling is based upon a questionable inference drawn from Petitioner's tax treatment of the 1944 payment. If the evidence was more

divided than it is, perhaps this inference could determine the case, but it stands alone against all of the other stipulated facts.

Petitioner respectfully submits that the real purport of the Tax Court ruling is to tax the 1944 transaction *i. e.*, "He in effect incorporated his going business in 1943 and he wants us to conclude the next year he took \$171,920.38 worth of earnings from his business and paid no tax." [Op. of Tax Court, Tr. of Record, p. 23.] But to do this the Court must ignore the demonstrated intentions of the parties and utilize an operation of law or constructive payment doctrine which is not supported by legal principle.

In the scope of review given here and in regard to the weight to be given the finding below, it should be kept in mind that all of the evidence is as plainly before this Court as it was before the Tax Court. There were no witnesses, one more believable than another. All of the facts are stipulated and it remains only to weigh them and determine which preponderates.

Petitioner submits that the evidence clearly substantiates his contentions and that there is no substantial evidence in support of the Tax Court's ruling which should be, accordingly, remanded.

Respectfully submitted,

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